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AN EVALUATION OF THE EGYPTIAN PRODUCTION CREDIT PROJECT

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Executive Summary

Production Credit Project

1. Overview

The Production Credit Project (PCP) was designed to increase private sector output by providing foreign exchange imports, short-term credit and by improving the capabilities of the Egyptian financial system. Initial project efforts were to be concentrated on foreign exchange imports and short-term credit. As the project developed it would be expanded to include the institutional development component.

When measuring project success against these goals it is clear that the goals were overly ambitious. It was expecting too much to task the project with achieving all of those goals. The achievement of project success was in large measure dependent upon the success of other Mission private sector projects and in a key sense, on the success of AID/GOE policy dialogue on macroeconomic issues.

The project was very successful in providing foreign exchange inputs to private sector industries that used those imports efficently. It was less successful in providing short and medium term credit. The credit market and institutional development side of the project never got off the ground.

The Evaluation Team identified a number of project difficulties and prepared a list of recommended changes. With such changes, a more effective and targeted project could be developed to build on the accomplishments of this project.

2. Procurement Implementation Experience

The Production Credit Project (PCP) was not a completly new effort; during the period from FY 1977 to FY 1981 $137 million had been disbursed under the private sector component of the CIP. The GOE, banks and private sector had gained experience and familarity with AID procurement regulations and procedures under the CIP. Drawing upon this experience, the Production Credit Project was carried on along similar lines with some important improvements.

The private sector CIP had relied on a quota-allocation system with the 5 public sector banks each receiving a share of the total program. The first change in the PCP was to expand the number of banks in order to encourage competition. In addition to the existing 5 public sector banks, 4 private sector banks

were added to the eligible list. Since the new banks were private sector banks, they brought a more market-oriented and service-oriented style of banking into the program. The second change in the program was to do away with the practice of giving each bank a fixed share of the total program. The PCP created a transaction-based, client-demand system. Each of the 9 banks was given an inital $3 million allocation. The remaining PCP funds were provided to those banks that were able to move their funds. Those that performed efficently and quickly received more funding. Those that lagged behind did not receive additional funding. The system worked well. By rewarding the efficent banks with more funds, the project was able to move AID funds quickly and effectively.

Transactions seem to be flowing to private sector banks at a rate which approximates their "fair share" of the banking market. The private banks processed 26 percent of the transactions valued at 35 percent of program value. While it had been hoped that the private banks would receive a larger share, they are generally small and new to the the market. They lacked many of the advantages held by the large, established public sector banks.

The original Project Paper implementation schedule anticipated final project disbursements to be completed by March, 1985. By December 9, 1984 USAID/Cairo had approved transactions valued at $54 million (80 percent of the program) and letters of credit had been issued for $37 million (55 percent of the program). Recent approvals have averaged $4-5 million a month which means that all funds should be allocated by February, 1985 with full issuance of all letters of credit and disbursements following closely behind. The project should reach an 80 percent disbursement level by March 1985 and reach 100 percent before the end of the fiscal year. That is reasonably close to the original implementation plan.

Of the more than $54 million in approved transactions, by far the greatest share (68 percent) has been for end-users of raw materials and capital goods. One of the criticisms of the Private Sector CIP had been that traders received nearly two-thirds of the funds. Traders often imported goods and some made a windfall profit reselling those goods to end-users. That problem has been virtually eliminated in the PCP. Traders have received a small share of funds and generally do not appear to be making windfall profits. Most traders using the PCP are distributors of U.S. equipment who are importing equipment and spares to support their regular distribution and service program.

A problem with the Private Sector CIP had been that a few companies and families had monopolized the program. That was not the case with the PCP. By limiting transactions to a maximum of $500,000 and allowing a firm to import only $1 million per year, the funds were spread among a wide range of companies. In fact, the average PCP transaction size was only $179,000 and only 8 exceptions were made for procurement over the $500,000 limit.

Analysis of the types of commodities financed and the industries receiving PCP imports showed that the goods were generally appropriate to Egypt's needs and were effectively used. Out of a total of 288 transactions, the Evaluation Team found only 3 or 4 commodities that were of questionable development value. Those commodities were eligible under AID/GOE rules but in Egypt's case they were of a "luxury nature" and did not appear to be of critical developmental need.

There was also a concern that "Law 43 Companies" (Egyptian/foreign joint ventures) might monopolize the PCP program. In theory, since "Law 43 Companies" have a foreign partner and thus access to foreign exchange, their need for PCP imports is less than that of wholly-owned Egyptian companies. The Evaluation Team closely examined all PCP transactions of "Law 43 Companies" and found that they received a very small share of project funds --only $2.3 million, or 4 percent of project funds. A close examination of all such transactions turned up only one case where the commodity being imported was not of high developmental value.

3. The Egyptian Credit Markets

The financial system has worked well in mobilizing short-term savings and providing short-term trade credits. Lenders are generally risk averters who require heavily collateralized loans, with a short maturity at high costs to the borrower. In order for the Egyptian credit market to develop into a more sophisticated market which provides term lending, both bankers and borrowers will need a higher level of confidence in Egypt's medium and long-term economic and political environment.

The Central Bank of Egypt (CBE) has a number of controls and limits on bank operations which restrict the development of a term credit market. In the interest of encouraging longer-term investments the CBE has set a maximum interest rate ceiling of

13 percent on industrial credit. In order to discourage short-term trade credits, a minimum interest rate of 16-18 percent has been set. Not surprisingly, banks are lending where the profit lies. They have nearly 85 percent of their loans in short-term trade credits with a maturity of one year or less. The Government regulation designed to encourage term lending has had the opposite effect. Another problem is that the CBE is not officially a lender of last resort. There is no Central Bank discount window in Egypt. Since banks cannot discount their loans, they do not have a readily available source of liquidity. This increases their desire to maintain most of their loans on a short-term basis.

The Evaluation Team analyzed local currency lending rates as they applied to the project. The Team was interested in determining whether project loans were being provided at realistic interest rates. The Team determined that short-term loans under this project cost the borrower between 22 and 28 percent interest. These rates are positive, even with Egypt's current inflation rate of near 20 percent.

Importers were reluctant to use the financing portion of the program because of the foreign exchange, maintenance of value requirement (MOV). An example will illustrate the problem. If an importer purchased $100,000 of imports under the project he could either pay LE 84,000 or, depending on the type of commodity, finance the LE 84,000 over a 1-3 year period. His local currency liability is fixed at the current foreign exchange rate of LE 0.84 = $1. However, if he takes the 1-3 year credit his liability will depend on the foreign exchange rate in effect when the loan matures. If the Pound devalues to 1.50 = $1 then his obligation would be LE 150,000. Since the risk of devaluation is great, importers were reluctant to take the MOV risk. Very few importers used the credit component of the project. If there is to be a credit component in a future project, the MOV requirement should be eliminated.

The failure to implement the training, technical assistance and studies component of the project has limited the developmental impact of the program. The Evaluation Team identified a number of training and institutional needs that could be addressed. They should be an integral part of any future program.

Project local currency generation are now placed in the general AID/GOE Special Account. The Team recommends that a separate Special Fund be set up for this project. While the actual uses would have to be determined by the design team that puts together the follow-on project, we recommend that the fund be used to encourage improvements in the credit market or to support export development.

The Private Sector Steering Committee was designed as a forum for exchanging views between AID, the GOE and the private sector. However, the Committee never met. The idea was a good one; a forum is still needed. Either the Private Sector Steering Committee or another organization should be activated.

If the banks do not have adequate incentives they will continue to concentrate on short-term credit. A strategy should be developed to create a positive interest rate structure for terms lenders. This may require negotiations with the CBE and the GOE. Such negotiations might logically be a part of other AID/GOE macro policy discussions.

4. Economic Analysis

The Egyptian economy is still evolving from the highly centralized system that was created during the 1950's and the 1960's. Many of the price distortions still remain. Rapid growth has been achieved in recent years through high levels of savings and investment, buoyed by worker remittances, oil export earnings and Suez Canal dues that helped to pay for rapidly growing imports.

The oil-related prosperity has masked some structural weaknesses in the economy which will need to be remedied. Among the most important of these weaknesses is the fact that industrial exports have stagnated for the past decade and recent sources of foreign exchange can be expected to become less reliable as the oil economy cools. Several policy reforms have been initiated by the government of Egypt and still others are needed to successfully address these problems. Credit needs of the private sector can be met by addressing them in light of these new circumstances.

Domestic credit has expanded rapidly in recent years. Indeed the government had to take action to moderate this growth in order to lessen inflationary pressures. Credit has grown as rapidly as is consistent with relatively stable prices. The more serious problem in the domestic credit market is the fact that interest rate distortions inhibit the flow of available credit into longer term productive investments. Aid to the private sector therefore need not focus solely on providing a larger volume of funds. Means should be developed to improve the allocation between short-term and longer-term credit. Institution building and removal of distortions in the domestic credit market (especially if the changes benefited industries in which Egypt has a comparative advantage), would aid the private sector as much or more than mere provision of additional funds.

The foreign exchange problem in Egypt is also as much one of allocation as it is of sheer quantity. Indeed in recent years, Egypt's banking system has been a net exporter of short-term funds to the Eurocurrency markets. Because of this, both private and government users often experience difficulty in acquiring foreign exchange. Private users can resort to the "own exchange" market, paying a higher exchange rate, but are normally limited to very short-term credit, and must bear with the additional inconveniences that occur in informal credit markets. To the extent that PCP institutionalizes a more formal credit system, and provides longer term credit, it serves a useful function for the private sector.

5. Conclusions and Recommendations

The Evaluation Team examined the Project's design to see if there were areas that could be improved. The following issues should be examined if a follow-on project is considered:

a. The present PCP facility serves a useful function in the economy by removing a source of friction in the access to foreign exchange that borrowers experience if they are forced to use the own-exchange market and by offering longer term credit.

b. A PCP facility could therefore form one component of a private sector credit program in the immediate future, provided that some adjustments are made in the mechanics of PCP to make it a true credit facility rather than a foreign exchange window.

c. These changes would include removal of the Maintainance of Value provision, the use of a higher exchange rate and/or interest rate, so that the effective exchange rate were no more than 20 to 30 percent below the "market rate". This last provision would compensate for the added costs of U.S. procurement requirements.

d. Unless these are additional charges, use of an overvalued "official" exchange rate for determining local currency repayment obligations under the Production Credit Project results in a significant net windfall in terms of real resource transfer to the Egyptian economy. This occurs in spite of the fact that in purely financial terms the subsidy is a transfer within the Egyptian economy.

e. While this subsidy is offset to some extent by U.S. source and origin requirements, it does not appear likely that an exchange rate subsidy of more than 20 to 30 percent can be rationalized in this way.

f. To the extent that there is a net subsidy, the effective cost of capital to the private sector is artificially reduced. This provides an incentive to invest in projects with lower than desirable rates of economic return. The result is lower output, employment and growth than would otherwise occur. When offering foreign exchange at lower than market rates, the donor must choose between providing all the credit that is demanded at that rate, or of restricting the amount while allocating it by nonprice rationing. In the former case, one must ask how long the donor intends to supply all that the market will take. In the latter, first come first served rationing will probably lead to an inefficient portfolio of investment projects.

g. As a rule, therefore, generalized exchange rate subsidies which lower the effective cost of capital are not an economically desirable feature to underpin an overall private sector strategy.

h. Events have increased the spread between the official rate and the free market rate. A spread that could be defended as appropriate to offset U.S. source and origin requirements at the outset of this project has now been exceeded. The applicable foreign exchange costs should be raised. There could still be a spread to offset higher U.S. source and origin costs. Beyond that, the Evaluation Team felt that the exchange rate subsidy issue is not an appropriate one to resolve in the context of this one single, and relatively small, project. There is a need for a flexible mechanism that can adjust effective foreign exchange rates over the life of the project. The appropriate forum in which to deal with exchange rates is at the Mission program/policy dialogue level, where incentives for policy reform can be brought to bear. Parity of treatment between the public and private sector import programs is also a consideration. When the CIP and other AID programs are brought under a more rational exchange rate, Production Credit should be as well.

i. In the Egyptian economy effective interest rates are in many cases negative. This discourages saving and leads to investment misallocation. Rational resource allocation would suggest interest rates sufficiently in excess of the rate of inflation to effectively ration capital and to stimulate saving. This issue, is however, not one which can be resolved in the context of a single project. It is a macroeconomic

policy objective to be negotiated at the highest levels by various donors, and not one which can be effected by partial adjustments in one sector or one project. It is important that project interest rates be tied in some way to either market or to central bank rates so that they would follow appropriate macroeconomic adjustments.

j. Medium and longer-term local currency credit, and export credit, may be as important a constraint as foreign currency availability. The Team recommends that in the future, credit programs aim more at these problems and take advantage of recent policy changes by GOE and efforts by other donors, such as the IBRD, to identify additional useful areas where credit needs should be met, rather than focusing exclusively upon imports. Firms and sectors with viable export potential and those for which comparative advantage considerations would suggest as efficient import-competing enterprises should receive special attention in designing future AID credit projects.

A. AID Assistance Strategy In Egypt

While political objectives (regional peace, stability and security) are the basis of U.S. assistance, the means of reaching those objectives are developmental -- economic growth through increased investment. Essential to that aim is encouraging the GOE to adopt economic policies that allow the efficent use of all resources.

The AID program was designed to increase investment in sectors where economic policy reforms were being made and where U.S. financing could achieve a significant developmental impact. AID will support efficient areas of the Egyptian economy, whether in the public or private sectors. Major areas of concentration are agriculture, industry, water and wastewater systems, health/population and education.

Starting in 1974, Sadat's "Open Door" policies began to redirect and revive economic growth through a massive rehabilitation of Egypt's infrastructure and capital plant. Economic liberalization was the key to the economic transition -- movement toward a market-oriented system for establishing prices and allocating resources. The current GOE Five Year Plan (1982/83 - 1986/87) continues the process with an emphasis on production efficency based on productivity gains while meeting basic human needs. The private sector has a key role to play in this effort. The Plan calls for 25 percent of investment to be in the private sector.

Both the GOE and AID view an efficient and growing industrial base as essential to achieving self-sustaining economic growth and as a partial solution to three of Egypt's closely linked economic goals:

--Increasing employment opportunities,
--Generating a growing source of foreign exchange earnings,
--Increasing the volume of goods available for domestic consumption and investment.

A vigorous private sector is essential to such an industrial strategy. Although AID private-sector assistance had been provided before 1977, it was not until passage of Section 9 of the International Security Assistance Act of 1977 that industrial private-sector development became a significant element in the U.S. assistance strategy for Egypt. Section 9, commonly referred to as the "Humphrey Amendment," placed special emphasis on expanding the role of Egypt's private sector. In response to the 1977 "Humphrey Amendment", AID began to develop its private sector/industrial strategy. The objective was to address the major constraints to private sector growth through financial and technical assistance. This would support Egypt's transition from a public sector dominated (and centrally controlled economy) to a more market-oriented mixed economy.

To a large extent, the Egyptian financial, legal and administrative system reflected the policies of a public sector dominated economy. Government policies and practices (including an extensive system of subsidies and price controls) distorted investment and marketing decisions and discriminated against the private sector. Initial AID efforts were designed to meet immediate needs--to provide foreign exchange and credit to private enterprises that could immediately increase production while encouraging institutional changes that would improve the business climate. The strategy did not focus on assisting specific types of enterprises or on stimulating growth in specific segments of industry. The approach was an interim step reflecting the need to provide immediate support while building more in-depth knowledge that could serve as a basis for a longer-term and more comprehensive strategy.

Basic to AID's strategy was policy reform -- movement of Egypt's industry toward a market-based economy through:

--More rational pricing policies,
--Greater managerial autonomy for public sector enterprises,
--Greater scope for private sector industry,
--Greater equality of treatment between the private and public sectors

Since the private sector is usually more efficent than the public sector in the "productive" or output-oriented areas of the economy, AID directed its assistance in those areas to the private sector. Private firms face a variety of constraints. AID's private sector program consists of projects designed to address those constraints by providing:

--Financial assistance to the indigenous private sector,
--Technical assistance to the indigenous private sector,
--Advisory services, training and equipment to improve Egyptian institutional capabilities to respond to private sector needs,
--Assistance to the Egyptian Government to identify and revise business laws and regulations which impede the private sector.

Listed below are the projects that preceded the Production Credit Project and the constraints those projects addressed:

--Commodity Import Program (CIP), private sector portion.
  Short-term credit and foreign exchange.
--Development Industrial Bank, I and II.
  Medium-term credit, foreign exchange and improved institutional capabilities.
--Private Investment Encouragement Fund (PIE).
  Medium-term credit, foreign exchange and improved institutional capabilites
--Private Sector Feasibility Studies.
  Investment information, incentives and improved institutional capabilities.
--Industrial Productivity Improvement.
  Transfer of improved technology and improved institutional capabilities.

B. Project Background and History

The predecessor to the Production Credit Project was the Commodity Import Program (CIP). The CIP was originally designed to provide commodity imports for Egyptian Government Ministries and public sector enterprises. In FY 1977, as a first step in its private sector effort, AID opened the CIP to private sector firms. Approximately 10 percent of CIP funds were made available to the private sector. In subsequent CIPs, a similar private-sector set-aside was provided. From FY 1977 to FY 1981 the Egyptian private sector received $137 million from AID CIPs.

Negotiations with the GOE on the Production Credit Project were difficult since, in many respects, it represented a departure from the old CIP program. AID was able to include a number of improvements and changes over the old CIP:

--Under the CIP only 5 Egyptian public sector banks were allowed to issue letters of credit. AID was able to have 4 private sector banks included.

--Egyptian "Law 43 Companies" were allowed to participate. These companies are Egyptian/foreign joint ventures that receive special tax holidays and other benefits. These companies represent some of the more dynamic new investors. They have brought in both foreign capital and foreign expertise that will help the Egyptian economy. AID did not want them to be excluded from the project.

--Credit terms were related to the economic life of the imported item:

3-year terms for capital goods
18-month terms for intermediate goods
12-month terms for raw materials
6-month terms for traders, buying for resale

--A Maintenance of Value (MOV) provision was added so that borrowers would pay full "value" for imports. They would also bear the risk of any devaluation.

--An institutional development component was included, and technical assistance, studies, and training, would help improve banking and credit facilities.

While all of AID's private sector projects included an institutional development component, each was also targeted at other constraints: long-term credit, investment information and incentives or industrial technology. The Production Credit project was designed to fill the remaining gap: short-term credit.

The Project was authorized on August 6, 1982. The Project goal was relatively straight-forward -- to help increase private sector output through the provision of short-term credit for the import of needed industrial raw materials, spares and capital equipment. Funds were made available to both private and public sector Egyptian banks for on-lending to private sector importers on a first-come first-served basis. A GOE Circular established eligible industries and commodities while AID Regulation 1 was used for AID procurement procedures.

While the project concentrated on short-term credit, it also had a framework for expansion to other components of the credit system. This institutional development side of the project included technical assistance, training and studies. The aim was to improve a variety of banking skills, including project

appraisal capability and bank management capacity to review, approve and monitor loans. Technical assistance funds could be made available for credit policy analysis and the development of new financial instruments for the Egyptian banking system. Private sector program and policy oversight was to be institutionalized in a GOE Private Sector Steering Committee. The Committee would monitor project performance and guide program management. Regular semi-annual AID/GOE consultations would include a broad range of issues including the financing requirements of the banking system, the business climate and the design of new financial instruments. The Central Bank was also to be involved in both the program and policy aspects of the project.

The project was sucessful in meeting its goal of providing short-term credit to finance U.S. imports. By mid-1984 project funds were rapidly running down and a $20 million add-on project was proposed. The institutional development side of the project had started out much slower with little progress demonstrated. The AID Project Review Committee was concerned about the foreign exchange rate used and other issues. It was decided that further analysis was needed before a follow-on project could be approved. More information was needed on the Egyptian credit market, private sector credit supply and demand, interest rates, the appropriateness of using a below market foreign exchange rate in the project and institutional development concerns. This evaluation was designed to help answer some of those issues.

C. Evaluation Methodology

The Project Paper anticipated that the project would be completed by March, 1985. An evaluation was planned for June, 1984, when the project would be nearly completed. While the project has followed the implementation timetable and will be nearly completed by March, 1985, the evaluation did not take place in June, 1984. Instead a mini-evaluation of project financial progress was included in a proposed $20 million project amendment which was considered in August, 1984. As discussed in Section B above, a number of policy questions were raised and the add-on project was not approved.

This evaluation took place in December, 1984. At that time, roughly 87 percent ($58 million out of $67 million) of the project's short-term credit funds had been committed. It was estimated that the full $67 million would be committed by February/March 1985. Since the project was nearing completion, the evaluation was treated as an "end-of-project evaluation."

It included a full analysis of the project design, progress against program objectives, and examination of the underlying project assumptions and measures of implementation efficiency.

The Evaluation Team spent a little over two weeks in Cairo. Given the tight timetable, interviews with all participants were not possible. Interviews were held with: the Egyptian Government Ministry that was responsible for the project (The Ministry of Planning and International Cooperation); all nine participating Egyptian banks; selected firms that used the project; and all concerned USAID offices. This allowed the Team to gain good insights into program operations. (See Annex 23 for a list of agencies and individuals contacted.) The evaluation included a review of recent industry and investment studies, a review of the Mission's arrival accounting system, and analysis of transactions by value, type of importer and type of bank.

The first step in the evaluation process was to prepare an evaluation outline of major topics to be examined (See Annex 2). This outline included all of the items in the Near East Bureau Project Evaluation Summary (PES) Part II. Special Emphasis was placed on:

--The economic impact of the project. The Team wanted to determine whether the "right" goods were delivered to the "right" industries to fulfill the program objectives.

--Egyptian credit markets. The Team was to analyze the functioning of the credit markets, institutional arrangements and credit availability in both foreign exchange and local currency.

--Efficiency of project operations. The Team wanted to measure the effectiveness of US/GOE procurement procedures.

The Evaluation Team then drew on the Scope of Work (prepared by USAID/Cairo) to set down the Evaluation Terms of Reference (See Annex 3). The Terms of Reference listed a series of issues that needed to be examined and a number of questions that needed to be answered. While it was recognized that the short time-frame would not allow a full examination of all issues, it was important to set them all down in order to start the process of identifying and then concentrating on those which were most critical to project success.

The Evaluation Team included the following members:

Joseph Lieberson, AID/W, PPC/Evaluation; Team Leader
Roy Grohs, AID/W, NE/DP; Economist.
Wolfgang Von Spiegelfeld, AID/W, SER/COM; Commodity Procurement Specialist.
David Rothstein, International Executive Service Corps; Development Banker.

D. Credit Markets

1. Description of Egyptian credit markets and banking system

a. Structure -- The banking system includes 59 banks of which 27 are commercial banking institutions. Five of these, which dominate banking in Egypt, are public sector, the other 22 being privately owned or operated as joint-ventures with foreign banks. Additionally, there are 23 direct branches of foreign banks and two "offshore" banking units. Except for the latter, all fall under the regulatory control of the Central Bank of Egypt (CBE). The banking system may best be characterized as extremely conservative with a high dependence on collateralized lending.

The CBE controls the level of credit available generally by three principal expedients: setting reserve requirements on deposits, fixing the loan-to-deposit ratio, and mandating the interest rates which may be charged for various types of credit. At present, a restrictive 65 percent limitation is in force as a lendable percentage of the deposit base, a low level for a developing country. Additionally, interbank deposits are excluded from this calculation, effectively barring a commercial bank from increasing its lending through market borrowings.

A liberalization trend in the loan-to-deposit ratio began in 1984. Export financing was excluded from loans, along with cash-secured loans. Capital structure was added to deposits. Depending on an individual bank's capital strength and participation in the export market, this could be of substantial assistance in generating additional lending capacity.

Aside from domestically-generated local currency deposits, banks generate lendable funds by attracting foreign currency deposits originating from the estimated $3 billion per annum sent home through official channels by Egyptians working abroad. The GOE is attempting to incentivare these remittances at the present time. There is considerable liquidity in the

bank foreign exchange area, but loan demand for these funds is limited, due to market considerations which will be explained later.

An additional constraint on the pool of available credit results from the internal limitations of the banks themselves. Client access to credit is limited to a percentage of the lending bank's net worth as are levels of a bank's equity participation in any project. Other limitations, of course, exist in terms of limits by economic sectors or related enterprises.

Aside from the above-mentioned control mechanisms on the pool of available credit, CBE also has applied expansion sub-limits to lenders' loan portfolios with varying percentages depending on the beneficiaries (commercial, trade, consumer, etc.). This has the effect, ultimately, of directing the expansion of credit toward sectors which the government intends to favor. An important adjunct to the availability of credit in Egypt is the curb or "street" market. Functioning on an extra-bank basis and as an integral part of Egyptian historical and religious characteristics, this market provides substantial funds on a partnership basis. This is due to the Islamic prohibition on charging or receiving interest. Lenders receive profit participations instead. Important and unregulated, this market supplies an amount of credit in the country which is significant but difficult to estimate.

b. Credit terms available. As a point of reference, it should be noted that the CBE fixes minimum and maximum interest rates for both deposits and loans; the former by maturity and the latter by both category and maturity. Rates for the most desirable purposes in terms of economic development, such as term project finance, are fixed below those for short term trade. However, banks will, therefore, gear their lending activities automatically to the permitted areas generating the greatest profit with the least risk. In principle, it is more profitable to lend for short-term trade transactions than for medium-term working capital purposes, due to the mandated interest rates, fees, etc. The risk-reward ratio is contrary to where it usually lies in the banking business (i.e. longer terms mean higher interest rates) and this results in bank loan portfolios of a short-term, trade-oriented nature. The GOE objective of encouraging longer term lending has been frustrated by a perverse schedule of interest rates.

c. Credit & Costs Under PCP

It is important to note that usage of the PCP results in higher costs to clients than would appear at first. For example, a client undertaking six month financing would pay minimum rates as follows:

1.	25 % downpayment	2.5 % p.a.
2.	Letter of Credit	2 % p.a.
3.	Loan	16 - 18 % p.a.
4.	20 % compensating balances	2 % p.a.
	Total cost	22.5-24.5% p.a.

There are several additional costs, including the necessity of giving a commercial or residential mortgage to secure term lending with high costs for registration, preparation, etc. Banks often charge management fees of 1/2 percent per annum and interest is payable monthly, adding approximately 1 percent p.a. Our best estimate is that the PCP client is paying rates of 22-28 percent p.a.

Alternately, a one year financing under the PCP would cost as follows:

1.	25 % downpayment	2.5 %
2.	Letter of Credit	2.0
3.	Loan	13.0
4.	Compensating balance	2.0
	Total	19.5 %

The same or higher additional cost factors should be assumed so that the rate would be 21 - 23 % p.a. all-in.

d. Term Credit Markets

In point of fact, the Egyptian credit markets are not unlike those of many third world countries where turbulent history and changing politics have taught both bankers and borrowers to be extra-conservative. Additionally, these markets are often not as undeveloped as they might appear to be, but have developed characteristics suitable for the nervous environment in which they must exist.

In order for the Egyptian credit market to develop into a more sophisticated market with term lending by local institutions, one would need a higher level of confidence by both bankers and borrowers in the medium and long-term stability of the economic

and political environment. This seems a bit much to ask of a private sector whose principal activities were nationalized while many owners fled the country thirty years ago. In short, time will provide the natural evolution of the credit market, if political and economic conditions cooperate. However, one cannot expect to see rapid changes in a market psychology which has evolved over thousands of years.

There are a series of specifics which give the credit markets their present structure. First, lenders grant loans on a heavily collateralized basis, with every guarantee available to them, often at considerable cost to the borrower. This, once again, is based on a self-defense school of banking. Second, the CBE is not officially a lender of last resort and has no discount window. Thus, banks cannot count on automatic injections of liquidity by discounting their eligible loans. Third, as mentioned above, short-term trade related financing bears higher permitted interest rates than longer term industrial project financing. Four, and quite important, under the laws, interest on personal bank deposits is tax free while loan interest is tax deductible.

At first glance, it would appear that these circumstances would produce a wholly short-term market as indicated by statistics showing approximately 85 percent of bank debt maturing on a short-term basis. However, the custom exists of "rolling over" secured debt for periods as long as several years and it is quite probable that up to 50 percent of the so-called short-term is renewed in that fashion. Obviously, given the tax structure, a cautious businessman has a considerable advantage in pledging his tax-free personal deposit to secure his company's tax deductible loan, thereby creating both capital and liquidity for his company with no direct injection of funds on his part. The bank should have no reason to call a loan secured by cash which therefore develops the characteristics of term credit without appearing to be so. CBE reporting, of course, shows it as short-term. However, the borrower is always running the risk of a change in environment where the unexpected occurs, and the argument that rollover credit is real term lending seems valid to everyone except a borrower who must depend on the renewals.

Long-term credit for industrial projects in markets such as Egypt (with the exception of the housing sector) has basically been the result of pass-throughs of government allocations via development banks, or of credits granted by foreign official lenders (IBRD, etc.).

Given their inability to generate matching deposits, the lack of additional profitability involved, the perceived greater risk, and limited personnel preparation, it is difficult to see how the Egyptian commercial banking system could become an active term lender at this point in time without changes instituted by the regulatory authorities. As for clients, the amount of information which they would have to provide a lender so as to induce the granting of term credit is beyond both the current technical and emotional grasp of the local entrepreneur who is generally not comfortable with the "full disclosure" concept.

e. Constraints to Private Sector Productive Credit

The principal constraints stem from three principal sources; market characteristics, impediments created by Central Bank regulations and constraints included in or produced by the program itself. The market psychology in Egypt having been sufficiently detailed in the preceding section, we can examine the others in some detail:

(1) The current exchange rate policy of the GOE creates distortions through the multi-tier market and occasional devaluations of substantial size. The lack of a forward exchange market has resulted in a speculative attitude among importers which prevents adoption of a medium-term viewpoint and which has affected this and other programs negatively. The importers under the PCP have failed to utilize the financing portion of the program recently due to their inability to judge the real costs of a foreign exchange-related credit and their unwillingness to bear an undefinable risk. The highly subsidized 0.84 = $1 U.S. rate encourages the utilization of the PCP as a foreign exchange "window" and does not encourage productive bank lending.

The solutions to the problem exist on general and specific levels. The GOE and CBE should be encouraged to progressively eliminate the subsidized exchange rates on the lower tiers. The institution of a "crawling peg" devaluation system in the future would be useful to dampen excessive speculation and permit importers to more accurately judge the costs of financing related to foreign exchange.

Failing the immediate implementation of such a program, it seems plausible to adjust the cost of the transaction. This would more accurately reflect the necessary rate of exchange at which the program could function efficiently without providing an unnecessarily large foreign exchange subsidy. Various solutions, including a higher exchange rate, variable downpayment level, and imposition of users fees, are detailed

in Annex 5. In any case, the model developed should include the ability to review and adjust conditions on a quarterly basis to take changes in market conditions into account.

(2) The lending rates established by CBE tend to divert a large percentage of loan activity to the trading sector due to higher permissable rates. Medium term lending, including project finance, can only be activated in the private sector when an expanded risk is justified by greater reward. The CBE should be encouraged to consider a program to reorient permissable interest rates so as to favor the granting of productive credit, either by lowering rates to the commercial/trading sector, or by increasing those for term credit.

(3) The maintenance of value requirement in financing terms under the PCP was instituted in an attempt to have the importer pay the real value of the merchandise purchased. In actuality, the provision caused an effect contrary to that which it was meant to produce. Rather than run the open-ended risk of a devaluation with an upward readjustment in the value of the loan, importers wisely paid cash at negotiation of documents and converted the risk to local currency. A participating bank admitted that they would not permit any client to run the risk of an unhedged position in this program, particularly since the bank must pay funds to CBE regardless of the borrowers' performance. If the PCP is intended to lead toward development of a more risk-oriented lending policy by Egyptian banks, it cannot include a provision which discourages borrowing entirely by imposing an excessive risk on the borrower. The solution would be to remove the maintenance of value provision from the program. Since any medium-term credit granted would place the credit risk on the local bank and would certainly be collateralized by the commodity imported, the bank should be taking these measures on its own to ensure the soundness of the credit. Otherwise, with the provision still in force, it will be necessary to wait for the market's perception that medium-term stability has returned to the valuation of the Egyptian Pound; perhaps a long wait.

(4) Training and technical assistance were budgeted at $1,000,000 in the program. There is no doubt that training in the CBE, in MPIC, in the participating banks and in the corporate private sector, is most necessary. The failure to produce a viable program has been an impediment to the value of the program. The program should be agreed and put into operation as rapidly as possible. The joint venture banks, with major foreign partners, may be presumed to have the capacity to train personnel here or at their head office. The Egyptian banks expressed strong interest in improving performance in several areas. The following proposals might prove useful:

(a) The CBE and MPIC should designate candidates to study development of productive financing markets in developing countries where considerable progress has already been made. This seems more logical than in the U.S. where money markets bear no relation to Egypt present or future. Brazil comes to mind as a country which has many parallels with Egypt and which is well along in capital market development.

(b) Egyptian commercial banks should send candidates with financial background (i.e. accounting) to study the methodology of financing expansion projects in U.S. banks. The Middle market, rather than Fortune 500 companies, should be studied, since there would be greater similarity of approach.

(c) Egyptian private sector companies should designate financial executives for training by banks and auditing firms to learn the proper means of preparing and presenting financial performance information to prospective lending institutions.

(d) All participating local lending institutions should designate the executives responsible for working with AID programs for futher training so as to fully comprehend the goals which The Agency is attempting to reach.

(5) The reach of the program in providing credit to the widest possible number of users in varied sectors of the non-government economy has been hampered by a failure to define the type of beneficiary who would be most desirable from AID's viewpoint. Although targeting the program does not seem a plausible solution, the banks should be given a clear idea of preferences. Future allocations to them should be based on the customers whom they include. These sectors would include the following:

--- firms which export;
--- firms which manufacture products in which Egypt has a comparative export advantage and which, therefore, have potential for export; and
--- firms which manufacture products where local production represents an economic advantage over imports.

Additionally, a study should be undertaken to find the best means of ensuring access to this facility by smaller, non-traditional companies which do not have access to bank credit at present. Perhaps an agent bank (DIB) could be designated and a risk-sharing program developed to create incentives for entering this area of lending.

(6) The Local Currency Special Fund, which receives the repayments in local currency from the program, has not as yet been put to any specific use. Realistically, it should be utilized in some activity which requires a budget allocation from the GOE, but which involves the development of the credit markets in Egypt. The Export Development Bank appears to be worth examination, since it is a GOE-IBRD joint venture. The fund could be used to fund an export guarantee program, provide long-term loans to export-oriented projects, or other desirable activities. Designation of these funds in such manner would add justification to the PCP as a program and close the circle in a way which provides maximum benefit to the Egyptian economy.

(7) The Private Sector Steering Committee was intended to provide policy and program direction on an ongoing basis. The purpose was to provide a forum for discussions between MPIC, AID and the participating banks. The Committee has not met and the guidance which it might have provided was never of benefit to the program. We continue to consider that this forum would prove useful to all parties concerned, and the ability to exchange views would have been a positive factor in resolving some of the program's difficulties.

2. Project as Provider of Credit to the Private Sector

a. Magnitude of intervention -The contribution of $ 67 million to the Egyptian private sector's import financing requirements is not an amount sufficient to create any major effect on that sectór nor on the economy in general. In terms of 1983 statistics, this amount would represent 1.52 percent of U.S. exports to Egypt, and 2.38 percent of exports funded by U.S. assistance. In terms of Egypt's total imports, the amount is less than 0.53 percent.

b. Benefit to Egyptian Banking System. The PCP has produced real benefits for Egyptian banks, both in terms of reasonable profitability and as a marketing tool to satisfy existing good customers and attract others. The commissions on letters of credit are attractive in themselves. Oddly, the maintenance of value provision in the PCP indirectly increased the profitability of these transactions to Egyptian banks by discouraging utilization of lending facilities linked to the PCP and encouraging the importer to borrow funds on a secured basis to liquidate his import obligation. These borrowings are considerably more attractive to the banks since the PCP obliges them to take the credit risk as a contingent liability for a fee. In lending the client funds to pay cash for the import, the bank is able to earn considerably more by using its own resources at no additional risk.

c. Effect on Production. As originally conceived, the PCP would be an effective means of facilitating the import of a variety of essential materials for productive areas of the private sector, with proceeds eventually credited to the GOE for developmental purposes. The constraints to accomplishment of these goals have already been noted in some detail. Additionally, the magnitude of the program is not such as to have any great effect on the local economy. It should be repeated that the program would come far closer to performing its intended role if it resulted in the granting of more liberal credit and provided technical assistance and training.

In its present mode of operation, PCP is essentially a cash transfer to the GOE with the worthwhile additional feature of providing economic movement in productive areas of the private sector. This is certainly superior to a direct cash transfer when analyzed in terms of its economic effect. However, the PCP has unrealized potential to produce a step-by-step modest improvement in the local lending markets, and therefore on production, if the constraints are removed.

d. Alternative Import Credit Available. Many of the imports under the PCP could have been financed by the standard system applied in European and other markets. The Egyptian importer makes no downpayment and receives 6-month financing in foreign currency at market rates. He purchases the exchange to liquidate his obligations at free market rates. Presuming a 25 percent price and freight differential on U.S. commodities versus European source, the importer is better off importing from Europe rather than utilizing the PCP with maintenance of value attached to his financing. A 10 percent devaluation would add 10 percent p.a. to a one-year financing and 20 percent p.a. to a six month financing. The users of PCP are opting at present for the most attractive option: limiting the exchange risk to the period during which the Letter of Credit is outstanding and refinancing their cash payment to CBE in local currency.

e. PCP and the Credit Markets - Summary Conclusion

The PCP could represent an effective tool for stimulating the development of Egyptian credit markets and has considerable potential. The program should be revised for this purpose, granting benefits to accomplish stated goals rather than in the current general manner. Program requirements, such as maintenance of value, which impede granting of productive credit, should be removed.

E. Economic Setting: 1/

1. Background

In 1974 with the introduction of the "Open Door" policy Egypt made a radical departure from the centrally planned economy that had been constructed during the late 1950's and the 1960's. One of the reform measures allowed foreign banks to establish branches or joint ventures. As a result, the number of commercial banks grew from the original 4 public sector institutions to more than 63 deposit banks ten years later. Foreign investment in other sectors also expanded rapidly under the generous provisions of Law 43 of 1974.

The economy was also buoyed by external factors during this same period. Recent oil discoveries placed Egypt among the ranks of oil exporters at a time when prices were rapidly escalating. Developments in World Petroleum Markets had two additional favorable impacts on the Egyptian economy. Skilled Egyptian workers found themselves in great demand in the booming Gulf States. A widened and deepened Suez Canal generated substantial earnings from oil tanker traffic through the 1970's and early 1980's.

As a result, the balance of payments pressures that had threatened Egypt before the Open Door, were eased, and government revenues increased. From 1979 to 1983/84, petroleum exports increased from $1.7 billion to $2.6 billion. Suez Canal revenues rose from $589 million to nearly $1 billion, while workers' remittances increased from $2.4 to $3.9 billion over this period. These flows were still insufficient to offset large and rising imports, so the current account balance was in deficit, ranging from $475 million to $2.3 billion during this period.

The 1982/83 current account deficit was $1.3 billion, and the estimated 1983/84 current account deficit was $871 million. Capital account surpluses in most years have offset current account shortfalls, yielding an overall balance of payments surplus in each year except 1980/81.

1/ This section on draws heavily from: International Monetary Fund, Arab Republic of Egypt--Recent Economic Developments, SM/84/136, June 19, 1984.

The result of all of these events, plus an increase in government investment expenditures from $1.5 billion in 1979 to $4.5 billion in 1983/84, was a very healthy rate of growth in real GDP. From 1975 to 1982 it averaged 8.4 percent per annum. From 1982-1984, this slowed to an estimated 7.0 to 7.5 percent.

The sectoral rates of growth diverged widely. Annual agricultural growth ranged from 1.4 to 3.0 percent, industry and mining from 6.2 to 7.2 percent, with petroleum growth varying from 14.5 to 25.4 percent annually.

Inflation accelerated from 12 to 13 percent in the late 1970's to an estimated 20 percent by 1983/84.

Despite steady movement towards liberalization of the economy, many sectors are heavily controlled. Prices of many products, notably agricultural products, are fixed at far below world levels, and basic consumer goods are heavily subsidized. At official exchange rates the Egyptian Pound is drastically overvalued. Heavily subsidized government plants still account for most of the output of heavy industry. The government budgets require large deficits to finance these activities.

These distortions have caused resources to flow into less heavily controlled sectors, and account in large part for the differential rates of sectoral growth. Annexes 17 and 18 show the sectoral breakdown of real GDP and of growth rates.

2. Future Prospects

The rapid economic expansion of the past decade masked some underlying structural difficulties that must be addressed in the coming years. While Egypt weathered the 1982-83 worldwide recession rather well, oil-related earnings from Suez Canal duties, worker remittances and oil export earnings cannot be expected to sustain high rates of growth into the 1990's. It is important that the economy be reoriented toward the production of agricultural and industrial products in which Egypt has a comparative advantage, and which offer promise as foreign-exchange-earning exports. This will require steady movement away from rigid price structures and toward a system of prices that will provide positive incentives to produce such commodities. It will also require a financial system geared to meeting the credit needs of both the public and private producers of products which Egypt can export competitively or which can be efficiently produced as import substitutes. The Production Credit Program can be viewed in this context.

3. Egyptian Industry

In the 1960's all heavy industries and most other industries were nationalized. Today the industrial sector is still dominated by government firms. Annex 19 lists those sectors controlled by the Ministry of Industry. Pharmaceuticals and some other areas fall under other Ministries. Even though Law 43 of 1974 induced an increase in the private sector's share, the data reveal that the public sector still accounts for 65 to 70 percent of the value of industrial production, overall, and in such areas as spinning and weaving the proportion is even larger. The private sector predominates in mining and refactory, while woodworking products and leather products are exclusively private. Other data reveal that the public sector is even more predominant in fixed capital formation. Private fixed investment represents only 20 to 25 percent of the total but this represents a marked increase from the 5 percent share of a decade ago.

Until recently the combination of high domestic demand and strong disincentives to production for export caused most industrial production to be sold domestically. In the late 1970's and early 1980's industrial exports stagnated, causing the export share of industrial production to fall from 14 percent in 1978 to 6 percent in 1982/83.

This trend was sharply reversed in 1983/84. Removal of foreign exchange surrender requirements helped to spur private exports. Public sector non-textile exports rose 41 percent, and textile exports by 29 percent to produce an overall 24 percent rise in industrial exports. Public sector industrial sector companies now meet 45 percent of their foreign exchange needs from export earnings.

It is within this industrial context that we evaluate the contribution of the Production Credit Program. Important changes in both the credit and in the international sectors help to define the foreign exchange needs of the Egyptian private sector.

4. Overall Monetary and Credit Developments

Regulatory changes have relaxed some of the restrictions on bank activities. Whereas formerly certain foreign-owned banks could engage only in foreign currency transactions, on a selective basis since 1983 they can do business in Egyptian Pounds.
In 1983, the items included in the numerator and denominator of the loan/deposit ratio were revised. In December of that year

the minimum interest rate for industry and agriculture was revised to 11 percent.

Table 1 reveals that changes in domestic credit rather than net foreign assets have underlain the expansion in private sector liquidity in the eighties. In 1981/82 the rate of increase in domestic credit was 44 percent. By 1982/83 it had fallen to 27 percent and was 28 percent in 1983/84. Changes in liquidity (money and quasi-money) can be seen to move with those of domestic credit. The Table shows that in 1980/81, growth in private sector credit far exceeded that for the public sector. This continued into 1981/82, until November, when the Central Bank imposed credit ceilings and a loan/deposit ratio of 65 percent. Other restrictions were also added. But enforcement came gradually and private sector credit still grew at a 66 percent rate, and the money supply expanded accordingly. By 1982/1983, the effects of the reforms were being felt, and the increase in credit was only 27 percent.

A more important factor in private sector liquidity in recent years has been credit to the public sector. In 1980/81, with oil revenues and canal dues rising, the government was a net depositor in the banking system. By 1981/82, net claims on the public sector doubled from the year before. By 1982/83, government adjustment in its budget again reduced credit to the public sector. In early 1983/84, borrowing by government authorities was again increasing public sector claims.

To summarize, changes in the overall volume of liquidity and credit in the economy in recent years has been the result of borrowing by the public sector and of regulations designed to fight inflation. While the rate of increase has slowed, the system still generates domestic credit at a high rate.

5. Project Financing

A crucial issue in assessing credit availability is the extent to which this overall volume of domestic credit has generated resource flows to specific needs, in particular to term-credit. The interest rate structure that emerges from the Central Bank's various regulations and ceilings has had the unintended effect of building in a disincentive for commercial banks to lend domestic currency for term loans, with a corresponding bias in favor of short-term commercial loans.

Table 2 reveals that banks effectively pay from 13 to 17 percent per annum to attract pound deposits. Yet regulations allow maximum charges of only 13 percent on loans to agriculture and industry. There is thus a built-in disincentive to lend to these sectors. On the other hand

permissable rates on commercial and services loans allow a positive bank spread. The net result is a domestic interest rate structure that favors lending for commerce and services and discourages extension of credit to agriculture and industry.

One of the most important impediments to private sector development therefore seems to be that there is lack of term funding in domestic currency. A credit program for the private sector should therefore focus on ways of removing or compensating for this important obstacle to private sector development.

Table 2 Egypt: Structure of Commercial Banks' Interest Rates since December 1, 1983
(In percent per annum)

	Interest Paid to Depositors	Effective Interest Cost to Banks 1/
Deposits		
6 months	9.5	12.67
1 year	11.0	14.67
2 years	12.0	16.00
3 years	12.5	16.67
5 years	13.0	17.33
Savings	10.0	13.33

	Interest Charged to Borrowers (Minimum)	(Maximum)
Loans		
Agriculture and industry	11.0	13.00
Services	13.0	15.00
Commerce	16.0	--2/

	Alternative Yields (Circa April 1984) (in percent)
Domestic rate of inflation	19.0
Approximate yield on foreign currency deposits held with domestic banks (in domestic currency)	17.2

Source: Extracted from IMF, Arab Republic of Egypt--Recent Economic Developments. June 19, 1984, p. 55.

1/ Interest rate paid to depositors adjusted to take account of the 25 percent cash reserve requirements on deposits. To obtain LE 75 in loanable funds, a bank must attract LE 100 in deposits. If the maturity of the deposit is one month, the effective cost of the loanable funds is 7.5/(75 x 100 pct.), or 10 percent for one year.
2/ No limit.

Table 3 shows the allocation of Commercial Bank credit to the private sector. The drastic changes in 1982/83 appear to reflect bank adjustments to the loan/deposit ratios and to attempts to comply with commercial credit ceilings.

Table 3. Egypt: Distribution of Credit from Commercial Banks to the Private Sector, 1980/81-1983
(In millions of Egyptian pounds)

Change During Period	1980/81	1981/82	1982/83
By economic sector			
Agriculture	37.7	82.9	52.6
Industry	284.4	456.8	360.6
Trade	481.3	848.4	96.6
Services	232.9	323.1	283.3
Household sector	152.8	63.1	0.5
Total 1/	1189.2	1774.3	793.6
By institutional classification of borrower			
Corporate business sector	392.8	565.1	389.2
Of which: Law No. 43 corps.	(321.4)	(444.7)	(395.6)
Unincorporated business sector	657.7	1168.6	471.4
Cooperative societies	8.3	22.4	2.2
Household sector	152.8	63.1	0.5
Total 1/	1211.6	1819.2	863.3

Source: From IMF, Arab Republic of Egypt--Recent Economic Developments, June 19,1984, p. 125. Data from Central Bank of Egypt.

1/ Totals differ between the two classifications, because credit to the corporate sector includes issues of securities that cannot be classified by economic sector.

While the Central Bank's attempts to curb inflation have led to a slowing of growth of credit to the private sector, there does not appear to be an aggregate shortage of domestic liquidity.

Adjustments to credit controls mask the effect that a distorted interest rate structure may have on sectoral allocations of credit. It nonetheless seems warranted to conclude that the

removal of these distortions, or providing means of compensating for them, would improve the structure of lending to the private sector, and should form part of a credit program.

6. Balance of Payments and Foreign Exchange Issues

It has already been noted that Egypt's Balance of Payments fortunes improved markedly in the wake of the Gulf Oil boom of 1979. The drop in petroleum earnings following the softening of the world oil market in 1981-82 was offset by a 13 percent reduction in public sector imports and increased worker remittances. By offering an exchange rate which was more favorable than the L.E. 0.84 per dollar official rate, more remittances were channeled through the banking system. Furthermore, remittances have increased. As a result, the current account deficit was reduced from a $ 2.36 billion in 1981/82 to an estimated $ 0.87 billion in 1983/84. Recent incentives are expected to stimulate non-petroleum exports, which have stagnated in recent years.

Egypt's overall balance has been kept in surplus by its capital account, which has been in surplus by over $1.0 billion in recent years, falling to $0.9 billion in 1983/84. The largest item is for project and commodity loans (about $0.9 billion yearly net in 1982 to 1984) and direct investments of $0.2 billion.

The net position of the Egyptian banking system has in recent years made it a net exporter of short-term funds, largely to Euromarkets. Data from Mullen's study are illustrative of this:

Year	Net Claims on Foreign Banks
Dec. 1978	1338
Dec. 1979	1361
Dec. 1980	1463
Dec. 1981	770

To the extent that such net claims continue it is difficult to argue that there is a global lack of foreign exchange in Egypt's banking system. There is a problem in repatriating it, channeling it to domestic uses, and in particular to longer-term development purposes.

7. The Exchange Rate System

Egypt has a complex multiple exchange rate system. Counting buying and selling ratio as separate, the number of distinct rates is around nine. LE .40 = $1.00 is still used for bilateral payments with the Soviet bloc, Mainland China and

North Korea. A 15 percent premium has been added, which runs through February 1987

These transactions move through the Central Bank pool, which processes petroleum exports, cotton, Suez Canal dues and some other transactions. Most transactions in this pool take place at LE .70.

There is also a commercial bank pool of foreign exchange which mainly deals in transactions related to workers' remittances, tourism receipts, non-petroleum exports, and public sector imports other than those with the Central Bank Pool. Since August 1981, this "official" rate has been approximately LE 0.84. In fact, in a series of adjustments to counter the effects of this overvalued rate, the Government of Egypt has effectively moved away from this rate by allowing more and more transactions to take place at higher rates. For all practical purposes, the LE 0.84 rate applies only to some bilateral and donor aid transactions. Most transactions now take place at LE 1.12 (buying) or LE 1.17 (selling). LE 1.14 (selling) applies to some public company purchases from public sector banks.

A free market exchange pool draws from the same sources as the commercial bank pool. In late 1984, this "own exchange" rate, or free market rate ranged from LE 1.28 to LE 1.30. It had earlier briefly and sporadically, hit LE 1.40 = $1.00.

Some recent changes have important implications for industrial strategy and credit policy. In April, 1983, foreign exchange surrender requirements were abolished for a wide range of transactions. Exporters will now be able to retain foreign exchange earned, whereas previously they had to surrender all but 10 to 25 percent. This will greatly improve export incentives to the private sector.

A committee has been established to set premium exchange rates in order to channel more worker remittances through the commercial bank pool. By mid-1984 there was evidence that attempts were being made to gradually unify the Central Bank and the Commercial Bank pools at what may eventually become a more unified exchange rate system.

In a related development, Egypt has taken some steps toward addressing the recognized problem of stagnating exports. A 1983 public enterprise reform bill was aimed at improving the efficiency of public sector companies. Other 1983 legislation provides for establishing an Export Development Bank for Egypt, scheduled to begin operation in January 1985. One function will be to provide investment funds for export-oriented businesses. The World Bank is scheduled to contribute to the

fund via a $125 million loan. Half of the funds are earmarked for private sector companies.

In summary, the Government of Egypt has recognized the need to stimulate export production if the economy is to sustain its capacity to earn foreign exchange into the 1990's. Since 1983, creation of more favorable exchange rates for exporters, more liberal treatment of export earnings, and direct credit aid to exporters have dramatically altered the potential for private business in the export sector. If further needed reforms are made, this will become an important area for donor-assisted financing.

8. Private Sector Strategies and Needs

Donor credit programs will have the most beneficial impact to the extent that they fit into GOE plans, and overall economic needs. Several studies have attempted to identify these needs.

In 1982, John Mullen presented the "Report of Private Sector Reconnaissance Team Visit to Egypt" to AID. Several key findings relate to the Production Credit Project:

--The team could not identify a single, simple cause for the limited amount of term lending to the private sector. A multitude of factors applied.
--Funds were available. Egyptian Banks in 1981 were net exporters of capital. The problem was that the funds flowed into the short-term Euromarkets rather than being channeled into productive investment.
--The recommended role for AID was to provide medium and long-term financing. Government policy changes to ultimately accomplish such financing through market mechanisms will evolve only slowly.
--AID financing must assure additionality, not substitution of AID funds for other sources.
--Because many changes will come slowly, the solution is not merely to "prime the pump" by injecting funds into the system. The study supported those AID projects which were aimed at attacking the various institutional constraints.
--Debt financing did not seem to be a problem for good projects with enough equity.
--Equity funding is an issue that should be addressed directly. Any term financing project should consider, as did the PIE fund, equity as well as debt financing.
--Insufficient available funds are being channeled into productive investment. However, foreign assistance funds should never be seen as a substitute for policy

change.
Means should be found whereby AID can use its position to stimulate policy change.

--Any AID Credit Project should stimulate term investment, not just provide it. There should be additionality.

--The cost of money including interest, fees, and charges to the borrower should be as close to market costs as possible, given the need to have the funds used efficiently.

--Some adjustment to the above must be made for U.S. source and origin requirements. But the exchange rate risk should not be borne solely by AID funds or by the GOE.

--AID could contribute much by establishing a fund to support the establishment of a discount facility.

Other studies have focused on industrial strategy. Paul G. Clark's 1981, "Private Sector Industrial Development Strategy." raised several points, including:

--Rapid expansion of industrial exports is probably the key component in an overall development strategy for Egypt.

--Changes in the conversion rate [since accomplished] for export earnings would significantly alter export incentives.

--[In addition to several GOE policy reforms], provision of low-cost export credit--e.g. credit to cover the lag between shipment and receipt of payment.

--Medium to long-term foreign exchange loans should be repayable in pounds [with low] exchange rate risk.

In 1981, Gustav Papanek submitted an Industrial Sector Strategy Assessment to USAID/Cairo. Major recommendations included the following:

--new investment should be shifted from industries where Egypt lacks comparative advantage to those where efficient production is possible.

--support for changes in the policy framework that guides decisions.

--subsidized credit for exporters. An "infant industry" argument can be made for improving private sector access to credit.

--interest rates would be set at medium to long-term average. (Lower than in 1981.)

--credit institutions assume exchange risk.

--indirect subsidies to encourage labor usage.

--collect data needed for effective cost-benefit analysis of projects.

The 1984 USAID/Cairo CDSS is the last to address major new industrial strategies. In that document, several previous studies of comparative advantage are reviewed. Among the specific recommendations in the CDSS, the following can be noted:

--support for expanding the share of the private sector in production.
--introduction of a special export credit at a preferential interest rate.
--Equal access to market terms of investment financing by both private and public sector enterprises. This should be achieved by making lending terms harder for public sector interprises, not by making them easier for private sector enterprises.
--equal treatment of private and public sectors in access to raw materials and foreign exchange.

9 Summary

--The Egyptian economy is still evolving from a highly centralized economy with many price distortions still remaining.
--Rapid growth in recent years has been achieved through levels of saving and investment, buoyed by worker remittances, oil export earnings and Suez Canal dues that helped to cover rapidly growing imports.
--This has masked some structural weaknesses in the economy that will have to be remedied. Among the most important of these are industrial exports which have stagnated for a decade.
--Several policy reforms have been made by the GOE, and more are needed. Credit needs for the private sector can be geared to fit these new circumstances.
--Interest rate distortions and other factors inhibit the flow of this credit into productive endeavors. Removal of bottlenecks in domestic credit would aid the private sector, especially if it stimulated production in comparative advantage industries.

10. Economic Impact of the Project

a. Project Share of Total Available Credit. The project disbursed $67 million in about 18 months. Total domestic credit outstanding in December of 1983 was LE 12.9 billion, of which claims on the private sector were LE 9.1 billion. Total additional commercial bank credit to the private sector in 1982/83 was LE 863.3 million ($675 million at LE 1.28).

From December 1982 to December 1983 claims on the private sector increased from LE 6.98 billion to LE 9.14 billion, an increase of LE 2.16 billion ($1.69 billion). Thus, as a percentage of total private credit, the program is small, but it represents on an annual basis, about 5 or 6 percent of commercial bank credit. Its major impact is on the industrial sector, where commercial bank credit in 1982/83 was LE 360.6 ($282 million).

b. Project foreign exchange as a percentage of total foreign exchange. The project flows are quite small compared to the $1.0 billion in annual Suez Canal tolls, the $3.0 billion in worker remittances, and the over $2.5 billion in oil export earnings that comprise the main sources of foreign exchange.

11. Project Disbursements and Foreign Exchange Rates

Through much of the life of the Production Credit Project, the dollar was appreciating strongly against other currencies, including the Egyptian Pound. In such an economic environment, a lending program tied to the official exchange rate is threatened with the possibility that it will turn into a mere foreign exchange window, with the credit aspects of the program becomong secondary. One force would tend to discourage borrowers from using the program. This is the fact that the rising cost of U.S. goods would make them less attractive relative to those from Europe of Japan. Table 4 shows that the Egyptian Pound has depreciated against the dollar at roughly the same rate as have other currencies during this period, thus worsening the competitive position of U.S. goods in Egypt vis-a-vis those from European sources.

Other forces worked in the other direction. At the beginning of the program, the own exchange rate for the pound was 34.5 percent higher than the official rate at which borrowers could purchase dollars through the program. This differential was at the upper end of the range necessary to compensate for the cost differential between U.S. and European goods. For at least some products, the foreign exchange differential was probably more than enough to compensate for the added costs attributable to AID source and origin requirements. As the Table shows, applications for use of the program were quite substantial from the outset. By late 1984, the differential between the official and the "own exchange" rates for the pound had widened substantially. The 1.34 L.E. rate for the dollar was 59.5 percent higher than the official 0.84 rate. We can see in Table 4 that the appreciation of the dollar would have increased the price of U.S. goods relative to those from Europe by about 15 to 20 percent. Clearly the difference in the cost of acquiring dollars through the program, compared to getting

them from the own exchange market, substantially overcompensated for the higher cost of U.S. goods. The Table does not reveal any clear correlation between the increasing costs of obtaining dollars in the unofficial markets and the rate of disbursement from the program. Quarterly data (not shown) suggest some tendency to increased usage, but the trend is not striking. The unusually large volume for November, 1984 reflect both an unusually high market exchange rate and the fact that borrowers rushed in to take advantage of a program that was known to be on the verge of exhausting its original allocation of funds.

While there is no clear sign of increased volume being induced by the exchange rate spread, the form of usage was influenced thereby. This resulted from the fact that the maintainance of value provision included in the program placed the full foreign exchange risk on the borrower. With no formal forward exchange market in pounds, this risk could not be hedged in that way. A formal devaluation of the pound would force a borrower to repay a term loan at a substantially higher rate. As the steadily depreciating own exchange rate increased the perceived risk of formal devaluation, borrowers hedged in the only way available. After purchasing dollars, they almost immediately repaid their loan either in cash or by borrowing pounds via a second loan. In either case, the effect was for all practical purposes to turn the credit facility into a foreign exchange window at extremely attractive rates.

The combined effects of the maintainance of value provision and the steadily depreciating pound were, ironically, to effectively convert the program in its latter days from its intended function as a credit facility into an immediate source of cheap foreign exchange.

Table 4 USAID/CAIRO PRODUCTION CREDIT PROJECT. PROFILE OF DISBURSEMENTS RELATED TO SPREAD BETWEEN OFFICIAL EGYPTIAN POUND EXCHANGE RATE, LE OWN EXCHANGE RATE, AND EUROPEAN EXCHANGE RATES

Month	Applications ($ Million)	Index of cost of $US in terms of Fr. Franc	Mark	Sw. Franc	Br. Pound	LE Own
Aug 1983	3.757	100	100	100	100	100
Sept	3.017	98	97	97	100	---
Oct	1.466	98	97	97	100	---
Nov	5.002	101	100	99	102	104
Dec	4.116	102	101	99	103	---
Jan 1984	5.207	106	104	102	106	---
Feb	3.353	98	96	99	100	106
March	4.697	98	96	98	103	---
April	4.501	102	100	102	107	---
May	3.113	103	101	103	108	106
June	4.508	105	103	106	110	---
July	3.808	109	107	112	114	---
August	5.301	109	107	110	114	111
Sept	3.292	115	110	115	118	---
Oct	3.861	117	113	115	121	---
Nov	7.148	115	113	117	124	119

Sources: International Monetary Fund, International Financial Statistics. Business Week

12. Economic Efficiency of Sectors Benefiting From the Program

The production credit program would have the most favorable impact on the Egyptian economy to the extent that it facilitated economic activities in which the country has a comparative advantage. These are sectors which have export potential or in which import substitution is economically efficient. In an economy with numerous price distortions, financial and economic rates of return differ, often drastically. In such cases the normal tests of profitability do not yield valid information about the efficiency of resource allocation in the economy. It is common in these cases to calculate shadow prices or to utilize Effective Rate of Protection (ERP) or Domestic Resource Cost (DRC) figures to identify efficient sectors in the economy. An activity with a positive ERP is in effect being subsidized by the existing

price/tax system, while one with a negative ERP is in effect being taxed by the system. Under the alternative measure of DRC, an economic activity with a value greater than one is inefficient, since it requires more than one pound of domestic resources to produce a pound of exports or imports. Table 5 illustrates results from one of several such studies of the Egyptian economy.

Table 5 Effective Protection and Comparative Advantage

(Selected Commodities)

	ERP	DRC
A. Desirable investment	+ is subsidy - is tax	The cost of producing a L.E. of exports/imports
Food (average)	- 92 %	.25
Vegetable oils	- 92 %	.10
Carpets	14 %	.80
Leather products	- 4 %	.63
Cement	- 71-84 %	.04-.48
Bicycles	--	.00-1.0
B. Probable investment		
Sugar	14 %	.77
Garments	44 %	1.89
Wooden furniture	--	.12-.55
PVC	--	.08-.09
Filters	--	.16
Cables	--	.08
C. Not recommended		
Frozen food	--	1.81
Nitrogen fertilizer	- 72 %	1.81
Iron and steel	599 %	4.80
Aluminum	69 %	131.00
Automobiles	305 (??)	1.85

Source: Gustav Papanek, "Industrial Sector Strategy Assessment. Industrial Development, An Overview", Prepared for U.S.A.I.D. Cairo, August 1981.

Although such calculations are subject to wide margins of error, they are helpful starting points for identifying the sectors with the most productive potential for the economy. Annex 20 reports the results of two studies which attempted to identify comparative advantage in selected Egyptian industries in which export potential exists and where further investment seems to be warranted. Industries where investment is not justified are also listed. Sectors where both studies agree may serve as a guide for judging investment and resource flows. In a few instances, notably in fertilizer, artificial fibres and consumer electronics the results are contradictory and are of little help. The remaining list, although flawed, can serve as a guide until much-needed further information is forthcoming.

The PCP was put to the following test. To the extent that it provided inputs to comparative advantage industries for which domestic inputs were not available, it was deemed that the economic impact was probably favorable. Furthermore, to the extent that a subsidy was involved, it is more justifiable, or at least less harmful, to the extent that an infant industry-like argument could be made for the beneficiary. Comparing Tables 6 and 7 with Annex 20 permits a rough means of assessment.

Table 6 SECTORAL DESTINATION OF PRODUCTS IMPORTED THROUGH THE PRODUCTION CREDIT PROGRAM
(Thousands of U.S. dollars)

Sector	Direct to End User	Via Trader	Total
Plastic Mfg. & Fabrication	8374.3	3324.3	11698.6
Agriculture (Poultry prod.)	7666.6	0.0	7666.6
Construction & Const. Equip.	3536.3	2891.0	6427.3
Textiles	6199.5	144.5	6344.0
Agriculture (crops)	1499.3	2732.6	4231.9
Undetermined	0.0	3956.1	3956.1
Household Furnishings	2210.3	697.0	2907.3
Metal Working & Fabrication	1000.0	672.5	1672.5
Trade & Other	1393.8	155.8	1549.6
Health Care	381.4	1033.9	1415.3
Cooling & Food Storage Equip.	512.3	621.9	1134.2
Miscellaneous Mfg.	870.6	0.0	870.6

Pharmaceutical Mfg.	705.9	0.0	705.9
Vehicle Spare Parts	38.5	590.5	629.0
Packaging & Container Mfg.	598.8	0.0	598.8
Agricultural Services	500.0	0.0	500.0
Auto Parts Mfg.	431.7	264.4	696.1
Mining	353.4	0.0	353.4
Food Processing	307.1	0.0	307.1
Ferrous Metal Mfg.	0.0	194.4	194.4
Aluminum	111.1	0.0	111.1
Education	73.0	0.0	73.0
TOTALS	36763.9	17278.9	54043.0
Percent	68.0	32.0	100.0

Note: Totals may vary due to rounding.

First we note that 68 percent of the imports under the program went to end users, so it is possible to identify the beneficiary sector. In those cases where the importers were traders, it appears from Table 7 that these are the sectors in which the use of an intermediary is economically justifiable, e.g. in the purchase of bulk seeds for farmers. There is on the face of it, no reason to a priori exclude traders from the program, unless the resource flows were to change in the future.

Table 7 SECTORAL DESTINATION OF PRODUCTS IMPORTED THROUGH THE PRODUCTION CREDIT PROGRAM
(Percentage Composition)

Sector	Direct to End User	Via Trader	Total
Plastic Mfg. & Fabrication	71.6	28.4	100.0
Agriculture (Poultry prod.)	100.0	0.0	100.0
Construction & Const. Equip.	55.0	45.0	100.0
Textiles	97.7	2.3	100.0
Agriculture (crops)	35.4	64.6	100.0
Undetermined	0.0	100.0	100.0
Household Furnishings	76.0	24.0	100.0
Metal Working & Fabrication	59.8	40.2	100.0
Trade & Other	89.9	10.1	100.0
Health Care	26.9	73.0	100.0
Cooling & Food Storage Equip.	45.2	54.8	100.0
Miscellaneous Mfg.	100.0	0.0	100.0

Pharmaceutical Mfg.	100.0	0.0	100.0
Vehicle Spare Parts	6.1	93.9	100.0
Packaging & Container Mfg.	100.0	0.0	100.0
Agricultural Services	100.0	0.0	100.0
Auto Parts Mfg.	62.0	38.0	100.0
Mining	100.0	0.0	100.0
Food Processing	100.0	0.0	100.0
Ferrous Metal Mfg.	0.0	100.0	100.0
Aluminum	100.0	0.0	100.0
Education	100.0	0.0	100.0

Table 6 permits some judgement about the flows, since end user industries can be identified. Unfortunately, many of the sectors receiving benefit from the program are not among those for which DRC or ERP have previously been calculated, and a definitive statement cannot be made about them. Plastic fabrication, poultry production, construction and textiles are the largest beneficiaries. ERP and DRC data would be needed to assess these, but at least they do not appear to be categories where investment is definitely not warranted. While plastic manufacture tends to be capital intensive, production of the derivative productes tends to be more labor intensive, and thus beneficial. The findings of Soliman and Ibrahim, The Productive Efficiency of the Broiler Industry in Egypt, March, 1983, cast doubt on the worthiness of poultry production, at least small scale broiler production. Construction is a nontradable commodity, and textiles are probably a comparative advantage industry, as are household furnishings, food processing and storage, metal working and packaging. In short, given that there was no attempt to target the credit program, a respectable amount of the inputs seem to have flowed in the direction of comparative advantage, or viable import-substitution industries. It appears that at least the program has not served to foster obviously inappropriate activities. More studies of ERP and DRC should be undertaken at the Mission to identify a more detailed list of comparative advantage industries so that future credit may be extended to such industries in order to stimulate exports and appropriate import-competing firms.

13. Issues

a. The Foreign exchange subsidy. There are two ways of looking at this question. The first is in purely financial terms. As pointed out elsewhere, since this is a grant, not a loan, the financial subsidy is de facto from the Central Bank of Egypt to the private sector borrower. This occurs because the Central Bank incurs an opportunity cost when it agrees to

accept repayment in pounds at a rate below the market rate (however that may be defined). In real economic terms, however, there is a subsidy to the Egyptian economy. By allowing Egyptian importers to obtain U.S. goods at a smaller sacrifice in terms of Egyptian or other goods foregone, there is a net resource transfer from the U.S. economy to the Egyptian economy equivalent to 40 or 50 percent of the face value of the credit. The subsidy to the economy is passed on to the ultimate importer/user of the product via the Central Bank's willingness to engage in the transfer noted above. This is offset to an undetermined degree by the U.S. source and origin requirements, and to the extent that the exchange rate differential merely compensates for this, there is no particular reason to quarrel with the the subsidy.

The evaluation team had neither the resources nor the time to accurately quantify the added cost of U.S. source and origin requirements for this project. Surely it will vary from commodity to commodity in accordance with the different relationships between weight/volume and product value. Based on anecdotal evidence gathered by the team, it seems highly doubtful that cost differentials would justify the current large spread between the "free market" rate of about 1.30 pounds per dollar prevailing in late 1984, and the "official" rate of .84 pounds. Data assembled by the Mission (see Annex 4) suggest that over the life of the Production Credit project, the difference between the official and the free market rates has averaged 20 percent. The only available systematic estimates of the added costs of U.S. source and origin requirements can be found in the 1981 Coopers & Lybrand evaluation of the Development Investment Bank project. By comparing average cost increases from the FOB value due to shipping and insurance for AID/DIB versus IBRD procurement, they found the increase over FOB to be 12.6 percent for U.S. source/origin.compared to 8.4 percent for European source/origin. The 4.2 percentage point differential was an average. In 52 percent of the cases, the increase was 10 percent or more. In 45 percent of the cases the increase was from 6 to 10 percent, while in 32 percent of the cases the increase was from 11 to 20 percent. Bankers were virtually certain that application of the free market rate would effectively shut down the project. At the .84 pound rate, funds have dispursed rapidly. Asked to estimate the borderline between ability to disburse and not to disburse, the bankers responded that this would occur at between LE 1.00 to the dollar and LE 1.10 to the dollar. This implies a source and origin cost of between 19 and 31 percent. One banker stated that a 20 percent differential would not make the program very attractive, and that a 30-35 percent exchange rate spread "is reasonable", because suppliers tend to raise prices when they

learn that a project is AID financed. GOE officials noted the same tendency. GOE officials estimate that source and origin-related costs range from 25 to 30 percent of commodity value over the past several years. Based on this eclectic evidence, the Evaluation Team concluded that exchange rate subsidies in excess of 20 to 30 percent would be presumed to exceed compensation for source and origin requirements. This could be an overestimate, because CIP shipments are sufficient to effectively fulfill the 50/50 shipping requirements, and the latter need not apply to most commodities imported under the Production Credit project. Furthermore, since many of the commodities purchased under the program are non-bulk items, Atlantic Coast Convention rules apply. It is therefore not entirely certain that source and origin requirements impose a very large additional cost to importers, as a percentage of the value of the products, but it is reasonable to believe that they have.

14. Conclusions

a. Unless it is compensated by additional costs, utilization of an overvalued "official" exchange rate for determining pound repayment obligations under the Production Credit project results in a significant net windfall in terms of real resource transfer to the Egyptian economy. This occurs in spite of the fact that in purely financial terms the subsidy is a transfer within the Egyptian economy.

b While this subsidy is offset to some extent by source and origin requirements, it does not appear likely that an exchange rate subsidy of more than 20 to 30 percent can be rationalized in this way.

c. To the extent that there is a net subsidy, the effective cost of capital to the private sector is artificially reduced. This provides an incentive to invest in projects with lower than desirable rates of economic return. The result is lower output, employment and growth than would otherwise occur. When offering foreign exchange at lower than market rates, the donor must choose between providing all the credit that is demanded at that rate, or of restricting the amount while allocating it by nonprice rationing. In the former case, one must ask how long the donor intends to supply all that the market will take. In the latter, first come first served rationing will probably lead to an inefficient portfolio of investment projects.

d. As a rule, therefore, generalized exchange rate subsidies which lower the effective cost of capital are not an economically desirable feature to underpin an overall private sector strategy.

e. Nonetheless, the Evaluation Team feels that recent events have increased the spread between the official rate and the free market rate. A spread that could be defended as appropriate at the outset of this project has now been exceeded, and to that extent the applicable exchange rate should be raised to reflect the originally intended differential. Beyond that, the Team felt that the exchange rate subsidy issue is not an appropriate one to resolve in the context of this one single, and relatively small, project. The appropriate forum in which to deal with exchange rates is at the Mission program/policy dialigue level, where appropriate incentives for policy reform can be brought to bear. Parity of treatment between the public and private sector import programs is also a consideration. When the CIP and other programs are brought under a more rational exchange rate, Production Credit should be as well.

f. In the Egyptian economy effective interest rates are in many cases negative. This discourages saving and leads to investment misallocation. Rational allocation of resources would suggest interest rates sufficiently in excess of the rate of inflation to effectively ration capital and to stimulate saving. This issue, is however, not one which can be resolved in the context of a single project. It is a macroeconomic policy objective to be negotiated at the highest levels by various donors, and not one which can be effected by partial adjustments in one sector. It is important that project interest rates be tied in some way to either market or to central bank rates so that they would follow appropriate macroeconomic adjustments.

g. The present project focuses on provision of foreign exchange. This is only one of the constraints facing the private sector. Institution building that would improve the banking system's ability to channel foreign exchange into longer term lending would indeed remove an important source of fricition in the private sector.

h. Longer term local currency credit, and export credit, may also be important contraints in addition to difficulties in obtaining foreign currency. The Evaluation Team recommends that in the future, credit programs aim more at these problems rather than focusing exclusively upon imports and foreign exchange.

F. Logical Framework Analysis

This section analyzes the Project Paper's Logical Framework assumptions and objectives against actual project performance. Annex 1 contains the Logical Framework matrix which this analysis is based upon.

1. External Factors and Changes in the Project Setting

On the positive side, Egypt fared much better than most LDCs as the world-wide recession of 1981-82 turned into the most severe recession of the last 50 years. Egyptian economic growth slowed, but still remained strong. Inflationary pressures, at near 20 percent in both 1983 and 1984 coupled with continued price controls on many products further distorted market-place signals. While inflationary pressures were being brought under control in most of the industrialized countries, high domestic inflation discouraged Egyptian exports. Even with periodic *ad hoc* devaluations, the Egyptian Pound became more and more overvalued when compared to the U.S. dollar. This created problems for the Project.

When the project was started the official exchange rate was LE 0.84 to the U.S. dollar while the "curb" rate was LE 1.10 to the dollar. The spread between the rate used in the project and the "curb" rate had widened as the "curb" rate increased to LE 1.30 = $1.00 by December 1984. The project did not include an effective mechanism to adjust its rate as the spread widened between the official rate and the "curb" rate. The project became a cheap foreign exchange window, which was never the project intention.

The Project Paper had anticipated that the GOE would continue economic liberalization as it liberalized and reduced economic controls and reduced disincentives facing the private sector. While there were some improvements, the private sector still had to contend with a large array of impediments. As one example, GOE interest rate ceilings discouraged the banking system from providing medium-term loans. This impeded project efforts to encourage term lending.

2. Project Assumptions

a. Goal Level

During the life of the project, the GOE continued to state its support for new private investment, both domestic and foreign.

President Mubarak in his address to the new cabinet on July 17, 1984 urged development in both the public and private sectors: "Our economic line is clear; it aims at developing the public sector, increasing production and improving productivity. Our line is also clear in enabling the private sector to have opportunities in all areas of production and investment."

While GOE policy proclamations continued to urge the private sector on, actual policy reforms were limited. There was some liberalization in the foreign exchange system, some prices were decontrolled and some of the more extreme price distortions were modified. On the whole the private sector still faced many contrary signals and bureaucratic obstacles. In the absence of improved policy, and with the continuation of price controls and uneconomic market signals the private sector was constrained. The banking institutions responded rationally to the system--they continued to make short-term (30-180 day), heavily collateralized loans. Private industry continued to concentrate on short-term investments with little interest in longer term investment or the export market--they were also responding rationally to the market signals.

At the sub-goal level it was assumed that project incentives would be adequate to encourage the banking system to lend to the private sector. This proved correct. The fees that the Central Bank of Egypt allowed banks to charge were adequate to encourage them to participate in the program. However, the major incentive proved to be the foreign exchange rate offered (LE 0.84 = $1.00). As the Egyptian Pound steadily depreciated over the life of the project, the project's foreign exchange rate was very attractive. The banks were able to move money easily at that rate. In fact the rate was so advantagous, banks reserved project funds for their best customers.

The log frame assumption that private firms would achieve a high enough rate of return on investment proved correct. Egyptian businesses were very profitable. In addition, the low foreign exchange rate offered by this project helped to increase that profitability.

b. <u>Project Purpose</u>

The Log Frame assumed the following: that the banking system would respond to the project initiatives; that the banks would expand their own internal capabilities; and that the private sector would have bankable projects requiring term financing. The first 2 assumptions proved correct. The banking system expanded
rapidly during this period. It continued to develop its ability to extend credit and provide financial service.

However, GOE policies set interest rates low for long-term loans and high for short-term credit. As one would expect, the banks found it more profitable to lend for 30 to 180 days at higher interest rates. Only a small percentage of loans had a maturity of 6 months or more. In addition, the project's maintenance of value provision discouraged borrowers from taking longer-term credit positions.

c. Outputs

The Log Frame assumed that the Private Sector Steering Committee would function and support the AID/GOE dialogue on private sector development needs. The GOE showed little interest in setting up the Committee. The Steering Committee was never formalized and never met.

d. Inputs

While the project negotiations and satisfaction of Conditions Precedent took longer than expected, they were successful and the project inputs were provided in a timely manner.

3. Measures of Log Frame Success/Achievements

a. Inputs

At the start of the project, progress was slow when measured against the Project Implementation Schedule. Satisfaction of the C.P.'s took much longer than expected. The implementation pace has picked up as Egyptian banks developed their procedures and skills in dealing with a new program. It now appears that all of the short-term credit will be committed by February/March 1985. That is consistent with the Project Paper Implementation Schedule. At the time of the evaluation (December 1984) the technical assistance, training and studies had not started.

While the dollar amount is small ($1 million), the failure to initiate the TA/training/studies is a cause for concern. All AID projects are designed to deliver development benefits. That is the short-run objective. The key is whether the longer-term objective is reached--to create the capacity within LDC institutions to cope with development problems on a self-sustaining basis. Few project benefits are sustainable without institutions and supporting policies in place. The fact that the project successfully provided the foreign exchange and short-term credit in an efficient and timely manner is to be commended. The failure to deliver the other inputs--TA/training/studies reduces the chance of reaching the

longer-run objective of improving the financial system's ability to support private sector development.

b. Outputs

Since the TA/training/studies input was not provided, the output target of "trainees using improved credit" could not be achieved. Since the Private Sector Steering Committee never was formed, the opportunity to improve policies and to engage in a dialogue on ways to support private sector development was limited.

The project was successful in expanding the number of participating banks from 5 under the CIP-Private Sector to 9 under this project. By bringing in the 4 private sector banks a healthy measure of competition was introduced. The total credit system was also becoming more competitive as new financial institutions entered the market. The number of commercial banks operating in Egypt had expanded steadily and totaled 54 by the end of 1984.

While there were more banks in the market and credit had expanded, the Project's maintenance of value (MOV) provisions and the GOE controls on term-lending interest rates discouraged banks from increasing their term lending. Short-term, highly collateralized credit was readily available. Longer-term credit was not.

c. Project Purpose

Data covering the expansion of short-term credit for 1984 were not available. Discussions with bankers and businessmen confirmed that there had been a substantial increase in short-term credit. As mentioned above, the absence of medium-term credit, the MOV provisions and the failure to implement the TA/training/studies component of the project restricted achievement of the full project purpose. Still, the project was able to meet its core purpose; foreign exchange and short-term credit were provided in an efficient and timely manner to support productive private sector enterprises.

d. Project Goal

The availability of project resources helped the private sector increase its output and employment levels. Problems at the input and output level of the Log Frame and with GOE credit policies restricted the project's ability to reach the sub-goal target of: "serving the full range of credit needs of the productive private sector."

When measuring project success against the Logical Framework goals it is important to note that the goals were large and that project funds were relatively small. Economic liberalization, improved credit markets and GOE support for the private sector were very ambitious targets. It was probably expecting too much to task the project with achieving all of those aims. The achievement of those goals was also dependent upon the success of other Mission private sector projects and, in the most important sense, upon the success of AID/GOE policy dialogue on macroeconomic issues which the total AID/Egypt program addresses. Project shortcomings reflect policy problems at a more macro level.

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